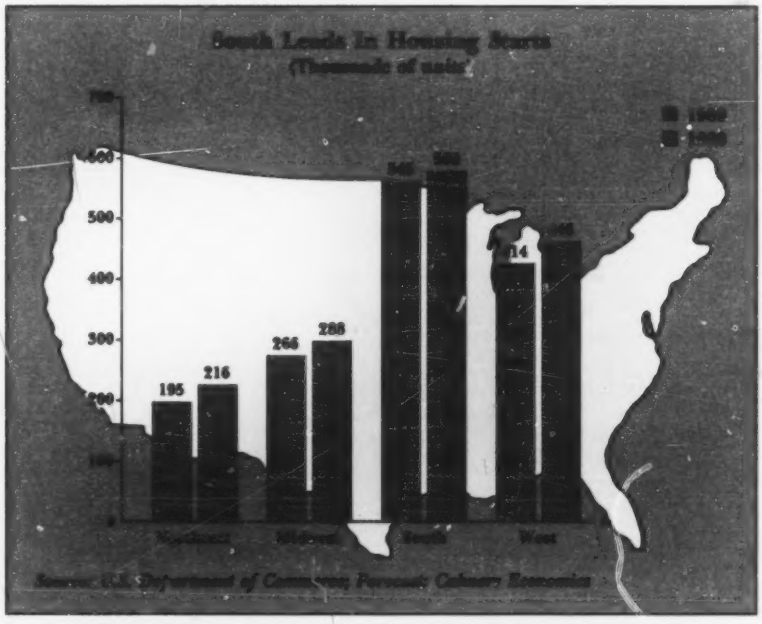
Why 1990 Will Be Good To Builders

Lower interest rates will ensure steady improvement in new construction and remodeling spending as the year progresses.

By Cahners Economics

As the new decade begins, the housing industry is on the road to recovery. Though housing starts and new home sales were discouragingly slow to reflect the steadily improving interest rate environment during the last half of 1989, declining levels of unsold inventory and slowly increasing sales prices have provided the extra shots in the arm necessary to begin to move the market along.

Our expectation is that the economy will grow by about 2.1 percent in inflation-adjusted terms during 1990, following two years when GNP growth averaged about 4.0 percent. The greatest sources of optimism for the economy this year and next are the downward trends in both inflation and interest rates. The Federal Reserve Board has spent the past two years attempting to rein in inflation without slowing the economy to the point of recession. This policy has had a painful impact upon home builders, as interest rates have risen sharply and many potential entry level and trade-up buyers have been priced out of the market.



The Fed's efforts, however, appear to have been successful — we expect inflation to average just under 4 percent this year. Like inflation, interest rates will continue to decline, at least through the first half of this year.

Following two years of only small gains in construction spending, 1990 will see a return to more normal patterns of growth. Spending for all types of construction — including new homes, non-res structures and infrastructure improvements — grew at an anemic 0.7 percent rate during 1989. Led by an early recovery in residential construction, and a somewhat later turnaround in non-res and heavy construction, we expect that total spending on new construction will increase 7 percent in 1990.

Construction dollars for the maintenance, expansion, remodeling and repair of existing space will continue to increase at a healthy rate during 1990.

Residential construction

After falling for three consecutive years — including a 4.6 percent decline this past year — we expect new residential construction activity to finally turn up in 1990. Housing starts should total about 1.51 million units this coming year, enough to more than recoup the losses of the previous two years.

The construction of single-family houses will account for almost all of the coming year's gain. The 1.13 million single-family starts we forecast for 1990 represents an improvement of 8.1 percent from 1989.

While we believe that the worst is over, total multiunit starts in 1990 will gain only marginally from 1989's nine-year low. While we are expecting the number of multifamily units built to plateau at about 380,000 units during 1990, the dollar value of construction should increase by an encouragingly healthy 6.1 percent in the year ahead.

Lower mortgage interest rates will work to the benefit of residential construction during 1990. Fixed-rate mortgages should average 9.2 percent by early summer,

By Kermit Baker, Daryl Delano and Stephen Evans, Cahners Economics, Newton, Mass.

and should rise only slightly to about 9.5 percent by year's end. Home sales will be further encouraged by smaller increases in home prices than during the mid- and late-1980s. After rising an average of almost 10 percent annually from 1986 to 1988, new-home prices rose by a less-daunting 6 percent during 1989.

Residential remodeling

A steadily increasing share of construction dollars is going toward maintaining, repairing and remodeling existing residential structures.

Higher interest rates and a general slowdown in the economy caused the rate of spending growth on these projects to slow during 1989. With the lower financing costs expected in 1990, however, we expect to see a return to the high rates of spending growth which have been in evidence for most of the last decade.

Improved sales of existing homes, and continued growth in household income, will help to raise 1990 repair and remodeling spending to a level of $114.5 billion — 9.6 percent above the 1989 total. The value of permits authorizing remodeling work has been rising most sharply in the West and Midwest regions.

Non-res reconstruction

Despite the lackluster spending trends in new non-res construction, expenditures on non-res reconstruction activities have continued to grow at a healthy pace. Permit values for reconstruction work on non-res buildings grew by just under 10 percent during 1989. Although we expect that the increase during 1990 will be less than half as large, spending on reconstruction work will continue to grow faster than will spending for new non-res construction.

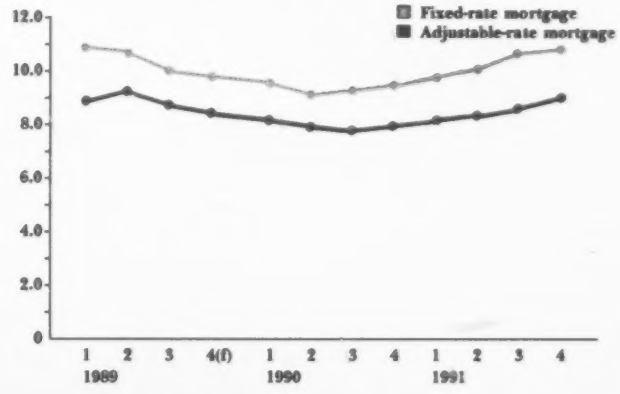
Finally, an important note for light construction contractors involved in — or considering becoming involved in — non-res work. A special federal government study released last year revealed that, dollar for dollar, the value of reconstruction work taking place in non-res commercial and institutional markets is more important than the value of new construction being undertaken.

Building materials

Price inflation for building materials was relatively modest for most of the early- and mid-1980s. In 1988, however, the producer price index for building materials shot up 5.6 percent — the highest annual increase in seven years. As the economy has slowed, however, and construction markets have become particularly weak, demand-induced upward pressure on materials prices has eased — a mixed blessing at best.

Continued on page 32

Mortgage Interest Rates Dip, Then Climb
(Quarterly averages—percent)



Source: Federal Home Loan Mortgage Corp.; Forecast: Cahners Economics

1990 Building Forecast, At A Glance

- **Housing Starts: 1.13 million single-family units; 1.51 million total units**
- **Remodeling: 9.6 percent increase in spending to $114.5 billion**
- **Non-Res: The action is in non-residential reconstruction**
- **Mortgage Interest Rates: Look for 9.2 percent by mid-summer**
- **Inflation: Just less than 4 percent this year**

Source: Cahners Economics

Remodeling expenditures expected to be $114 billion in 1990

Continued from page 29

As a result, we are forecasting an inflation rate for all construction materials that averages 2.6 percent this year.

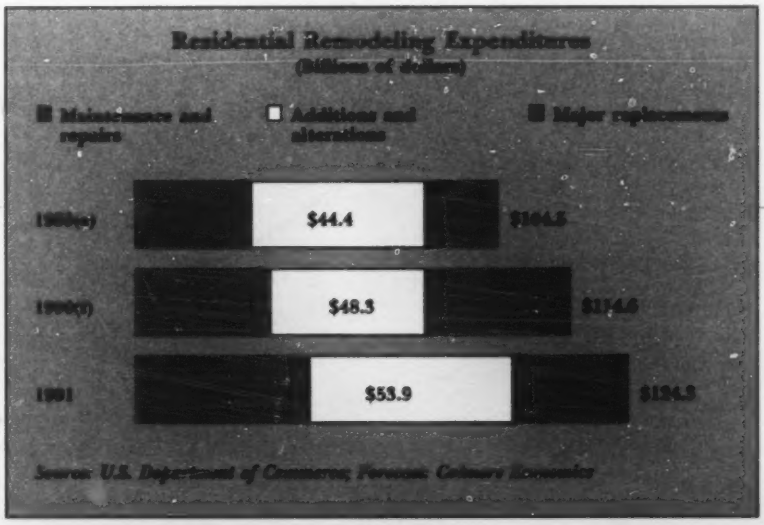
Regional trends

The New England states have borne the brunt of the region's slowdown; the value of building permits authorizing new residential construction plummeted almost 30 percent during 1989. While the Middle Atlantic states have also seen a decline in new home permits, values have fallen only about one-third as sharply as in New England.

The Midwest and South both recorded little change in the value of residential permits issued last year. Within these two large regions, states in the East North Central area (including Michigan, Ohio, Illinois, Indiana and Wisconsin) and the West South Central area (including Texas, Oklahoma, Louisiana and Arkansas) fared the best with the value of new home authorizations rising by an average of 5 percent during 1989.

Although the gains in the West South Central states came atop a severely shrunken base, it is the first sign that new home construction in this oil-industry-dependent area is at last starting to move in the right direction.

The West was the only region to record an increase in residential building permit values last year. However, there were sharply different trends apparent among states within the region. Residential permit values in the energy-dependent Mountain states were little changed from a year earlier. However, in the Pacific states (most dramatically, in California) permit values rose by 11 percent. An even larger gain of 14 percent was recorded in the value of permits authorizing residential remodeling in the Pacific states.



Summary outlook

In summary, we see 1990 as a year when home builders and remodeling contractors will begin to see a real rebound in activity from the steadily declining levels of the past three years.

Still, it's important for builders to acknowledge — and to plan for — the new reality of the 1990s housing market.

Inexorable demographic forces will place constraints on the volume of new construction that will take place this decade. Continuing declines in the number of young households being formed will result in lower levels of construction than we have become accustomed to.

Nevertheless, builders who adapt to the changing needs and expectations of home buyers — and who diversify into the increasingly important residential and non-res remodeling markets — will continue to do well during the 1990s. □

Top Markets In 1990 For New Residential Construction And Residential Remodeling
(Projections of dollar value of building permits)

New residential construction	Residential Remodeling
1. Los Angele Long Beach	1. Los Angeles-Long Beach
2. Riverside-San Bernadino	2. San Francisco
3. San Diego	3. Washington, D.C., Md., Va.
4. Seattle	4. Philadelphia
5. Sacramento, Calif.	5. Chicago
6. Chicago	6. Baltimore
7. Washington, D.C., Md., Va.	7. New York
8. Atlanta	8. Boston
9. Oakland, Calif.	9. Anaheim-Santa Ana, Calif.
10. Orlando, Fla.	10. Newark, N.J.
Forecast: Cahners Economics	

Nothing To Jump Up And Down About

Economists for the major real estate trade associations call their economic outlook for the year "boring." Listen to John Tuccillo of the National Association of Realtors: "Next year's economy, in short, is a crashing bore."

Said David F. Seiders of the National Association of Home Builders: "The national forecast looks downright boring on paper, with gentle contours that look nothing like the roller coaster rides of the past."

Cahners Economics has a detailed forecast for housing, remodeling and non-residential building beginning on page 28.

But these two don't agree on everything. Seiders is betting that a soft landing for the economy will occur soon. But Tuccillo said in November that the oft-predicted soft landing has, in fact, happened.

So what's a builder to make of these economic forecasts?

Seiders sees 1990 shaping up this way:

- Economic growth of less than 2.5 percent for several quarters, but no recession
- Stabilization of the unemployment rate in the 5 to 5.5 percent range, with only a slight increase in early 1990
- Stabilization of "core" rates of inflation around 4.5 percent in the very near term, with only a slight improvement by mid-1990

Lyle E. Gramley, chief economist for the Mortgage Bankers Association expects fixed-rate mortgages to be in the 9.25 to 9.50 percent range until mid-1990 and then to average 9.50 percent for all of 1990. NAR's Tuccillo agrees.

NAHB forecasts about 1.45 million housing starts in 1990, up almost 4 percent from 1989. The single-family component is expected to move up nearly 5 percent, while the multifamily component should edge down to about 375,000 units.

Tuccillo said that with the slowing of the economy, he expects that the Consumer Price Index to advance only 4.1 percent in 1990, down from 1989's inflation rate of 4.8 percent.

Seiders said forecast risks associated with a soft landing scenario are high because of the fragile condition forecasted for the economy. "The uncertainties are high particularly because we don't really know what the impacts of the thrift reform legislation will be on the housing finance system."

The weakest areas of the country are New England and the Middle Atlantic states, he said. The Oil Patch market, including the West South Central states, will move at about the same pace as the national market. And the Rust Belt, he said, will continue to gain share, but only gradually. The Pacific area should pick up a bit more share, rising to 22 percent of national housing activity. □

Why So Boring?

Economist John Tuccillo of the National Association of Realtors said that the economy looks so bland because of the fundamentals driving it.

"The baby boom generation is reaching its maturity and filling the economy with experienced productive workers who are able to sustain an expansion of production and consumption with little strain. Any potential strain has been siphoned off by foreign markets," Tuccillo said.

"We ought not take the stock market seriously; it has taken on the clubby atmosphere of a fraternal lodge or labor union and probably has as much impact on the economy.

"And the federal deficit could come home to roost. But for the most part, 1990 looks a lot like 1989—a year of steady growth against the backdrop of moderate inflation and interest rates." □

Corrections

Corrections To The December 1989 Consumer Survey:

The "Consumers Want" and "Builders Offer" column headings were omitted from the tables on pages 116 and 117 of the December 1989 *Professional Builder*. The first column shows the percentage of consumers who would pay extra for the product. The second column shows the percentage of builders who now offer that product as a standard feature.

The following chart was color-coded incorrectly. This is the corrected version.

Price, Not Promotion

Buyer type	Grand opening	Discount	Free gift
First-time	24.1	68.3	18.5
Move-up	18.3	68.8	12.9
Empty-nester	21.1	71.1	7.9
Retiree	29.7	65.6	4.7

Management Short Course: Understanding The Balance Sheet

Look beyond the profits. Balance sheet ratios can give a more complete picture of the health of your company.

By Frank Newton and Charles G. Graham

For an industry as capital incentive as home building, we are unusually ignorant of the balance sheet and its contribution to our understanding of financial performance.

The focus of many builders is on the income statement rather than an integrated understanding of both the income statement and the balance sheet. The better a builder understands the relationships between the two statements, the better the financial decision making.

A balance sheet is simply a statement that contains a list of everything that your company owns (its assets), everything your company owes (liabilities) and the difference, or what your company is worth (the equity or net worth).

For a better understanding of why you need to know what's on the balance sheet, it helps to compare the balance sheet and income statement to a savings account and its interest income.

Let's say that an individual opens a savings account which earns 5.5 percent annual interest. As time goes by, the account continues to increase through additional deposits and the retention of the interest in the account. This account continues to pay the 5.5 percent interest but economic conditions change and other types of accounts are created which pay up to 10 percent interest. An astute business person would immediately redirect the investments from the savings account into the higher paying account.

Now, let's liken the balance sheet of a company to the above savings account. The builder's balance sheet contains all of the assets which have been invested. The builder should expect to get the maximum return on these assets which primarily are land and structure inventory.

An astute builder will carefully control the quantity and quality of land inventory so as to maximize the return and minimize the investment.

Following are six ratios to compute for your own company and suggested targets to shoot for.

Debt to equity is a measure of financial risk. The higher the debt/equity ratio the more risk the builder has taken in the form of financial obligations.

To compute this ratio, divide the total debt of a company

Continued on page 60

N&G Builders Inc.
Balance Sheet
Dec. 31, 1989

Assets		
Cash		$50,000
Accounts receivable		15,000
Notes receivable		24,000
Inventories:		
land	$ 819,900	
structure costs	2,900,500	2,900,500
Other assets		5,000
Fixed assets		29,000
Total assets		$3,025,500
Liabilities		
Construction loans payable		$2,174,100
Notes payable		
Accounts payable		12,000
Accrued payables		25,000
Income taxes payable		16,000
		$2,227,100
Net worth		
Capital stock	$ 5,000	
Retained earnings	771,700	$776,700
Total liabilities and net worth		$3,003,800

N&G Builders Inc.
Operating Statement
Year Ended Dec. 31, 1989

Sales (units closed during the period)	$4,220,300
Cost of sales:	
land	761,100
structure costs	2,114,100
indirect job cost	175,000
Total cost of sales	$3,050,200
Gross profit	$1,170,000
Operating expenses:	
financing expenses	$ 225,500
marketing expenses	202,500
general and administrative expenses	210,750
	$ 638,750
Operating profit	$ 371,550
Other income (expense)	3,000
Net profit before income taxes	$ 374,550
Provision for income taxes	149,320
Net profit for the period	$ 225,231

For information circle 22

Sales to assets measures a builder's ability to select the right things to do

Continued from page 54

by the net worth. It is suggested that the builder attempt to manage the debt/equity ratio between 3- and 4-to-1. A 3-to-1 ratio should be maintained in times of prosperity while a 4-to-1 ratio would probably evolve during more difficult economic times.

Sales (or revenues) to assets measures a builder's ability to select the right things to do. Over time, the builder should push to reduce the dollars of assets necessary to obtain every dollar of sales.

Inventory turn measures the efficiency at which a builder is operating. The higher the turn, the greater the efficiency. Standards for inventory turn of land as well as structure should be established and measured.

It is suggested that no greater than a three-year supply of land should be inventoried by larger builders while smaller builders should arrange to acquire their lots as they are needed.

Depending upon the type of units being produced and whether you are a tract or custom builder, structure inventory turn will range between 2 and 4. A turn of 2 means that on average it took six months to build and close out each unit.

At the other extreme a turn of 4 means that a builder can build and close out a unit in three months. The higher the turn, the less the construction loan interest.

Inventory to sales determines the efficiency with which a company controls its inventories. In order to reduce risk, it is recommended that this ratio fall within a range of 35 percent to 45 percent. If a builder's ratio strays too far from the top of this range, this should warn him to take action to either increase sales or decrease inventories or a combination of the two.

Return on assets tells a builder how efficiently he has invested his assets. Different types of company assets would be expected to generate different rates of return.

Return on equity computes the total return that the builder received on the equity investment in the company. The equity investment is comprised primarily of the capital stock and retained earnings of the company, if it is incorporated. This ratio is computed by dividing the net profits of the company by its total "net worth" or "equity." The more highly leveraged a company with good profitability, the higher return the builder obtains on the investment.

Conversely, the higher leveraged company during adverse economic times can face financial difficulties. A minimum of 20 percent return should be expected. □

Frank Newton and Charles G. Graham are partners in Newton Graham Consultants, Charlotte, N.C. Newton was chief financial officer of the John Crosland Co. and Graham was chief marketing officer.

Computation Of Ratios

Debt to equity ratio	= Total debt / Net worth	=	$2,227,100 / 776,700	= 2.9-to-1
Sales to assets ratio	= Sales / Assets	=	$4,228,200 / 3,003,800	= 1.4-to-1
Inventory turn	= Cost of sales structure costs / Inventory structure costs	=	$2,114,100 / 2,060,300	= 1.03-to-1
Inventory to sales	= Inventory / Sales	=	$2,880,200 / 4,228,200	= 68%
Return on assets	= Net profit / Assets	=	$232,200 / 3,003,800	= 7.7%(1)
Return of equity	= Net profit / Net worth	=	$232,200 / 544,500	= 42.6%

(1) It is assumed that assets averaged $3,003,800 during the year.

How Large, Public Builders Stack Up To Industry Norms

	Profit margin	Return on common equity	Return on total assets	Revenue to asset	Debt to equity
Residential Construction†					
Industry composite	2.7%	11.0%	2.9%	107.0%	80.0%
Centex	2.6	10.4	4.5	171.0	36.0
Hovnanian Enterprises	6.8	21.9	6.1	91.0	102.0
Kaufman & Broad Home	7.2	20.7	11.4	157.0	70.0
Lennar	5.4	11.9	4.1	75.0	57.0
NVR	2.5	30.7	1.7	66.0	200.0
Ryland Group	3.0	24.2	8.6	288.0	68.0
Standard Pacific	21.5	35.9	13.3	62.0	0.0
Toll Brothers	8.6	53.1	6.0	70.0	96.0
UDC Universal Development	12.6	36.0	18.2	144.0	124.0
U.S. Home	0.1	2.8	0.1	76.0	112.0
Real Estate†					
Industry composite	−8.5%	−21.6%	−2.7%	31.0%	177.0%
General Development	0.7	3.9	0.4	60.0	235.0
PHM (Pulte)	4.8	13.0	1.2	25.0	81.0
General Contractors†					
Industry composite	2.4%	8.7%	3.8%	150.0%	30.0%
J.M. Peters	10.0	33.7	7.5	75.0	0.0

†As classified by Media General.
Source: Media General ratios as of late October 1989, compiled by Professional Builder.